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The choice between judicial and administrative sanctioned procedures to manage liquidation of banks: A transatlantic perspective

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1. Introduction

Following the great financial crisis in 2008, preventing future bail-outs for large, systemically important banks while minimizing the repercussions of bank insolvencies on the stability of the financial system and the economy at large has become a key policy objective for international standard-setters as well as national and supranational policy-makers and regulators. The focus has been not just on the prevention of systemic contagion and the protection of insured depositors and client assets and monies, but also, first and foremost, on minimizing the public and private costs of containing bank crises. Given the global nature of the financial crisis and the cross-border economic implications, it is hardly surprising that initiatives to accomplish these objectives have been global in scope, while their implementation has principally been guided by the legal frameworks in the respective jurisdictions. Nonetheless, all have been focused on the specific challenges encountered in transnational bank crisis resolutions.

The European Union (EU) and United States (US) frameworks establish a set of tools to ‘resolve’ a failing bank without recourse to formal insolvency proceedings, thereby creating a clear policy demarcation between resolution and insolvency. Within this framework, which draws from the Financial Stability Board (FSB) approach, ‘resolution’ may be understood as functional alternative to court-sanctioned traditional insolvency procedures such as liquidation and administration, or as an essential prelude to applying for insolvency proceedings.¹ In the EU it has become the preferred

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¹ Financial Stability Board, ‘Key Attributes of Effective Resolution Regimes for Financial Institutions’ 2011, www.financialstabilityboard.org/publications/r_111104cc.pdf. An updated version was released in October 2014, www.fsb.org/wp-content/uploads/r_141015.pdf.

approach in bank resolution plans of national resolution authorities, partly reflecting the lack of credibility and feasibility of the national bank liquidation processes.²

Resolution established a regime that should impose broadly similar economic consequences for bank owners, management, and major stakeholders while avoiding potential detrimental knock-on effects that could result from the application of the traditional procedures under insolvency law. In this context, the principle that losses in bank debt should be borne primarily by bank owners and investors became paramount, while the ranking of claims in this context broadly, although not fully, follows the principles of general insolvency law, and creditors should receive no less because of 'resolution' than they would have received in a traditional insolvency liquidation of the relevant institution.³

The introduction of resolution tools tailored to the needs of insolvencies of large, complex, internationally active banks and banking groups has not removed the existing approaches and procedures for dealing with institutions of 'no public interest'. Indeed, within Europe the BRRD expressly provides that where a failing bank's outright liquidation under general insolvency laws would not give rise to concerns regarding public policy interests (the 'public interest' test), 'resolution' under the BRRD should not be allowed and the relevant bank should be liquidated in ordinary insolvency (bankruptcy) proceedings instead.⁴ Against this backdrop, Bénassy-Quéré et al.

² See Section 2.3 of the Introduction to Resolution Planning: *'The first step is to determine whether winding up under normal insolvency proceedings would be credible and feasible, because this is the normal option for a failing bank. Only if this is not credible or feasible, the factors determining the preferred resolution strategy and its implementation are described.'* See https://srb.europa.eu/sites/srbsite/files/intro_resplanning.pdf.pdf.

³ Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council Text with EEA relevance (BRRD) Art. 34(1)(g) and SRMR Art. 15(1); see G Marc, Valuation of Difference in Treatment Ex Post Resolution – No Creditor Worse off than under Liquidation (NCWOL), 139–42 in World Bank, *Understanding Bank Recovery and Resolution in the EU: A Guidebook to the BRRD*, (2017). See also the communication from the Commission on the application, from 1 August 2013, of state aid rules to support measures in favour of banks in the context of the financial crisis (Banking Communication) 2013/C 216/01 referred to in Kotnik and others, ECLI:EU:C:2016:570.

⁴ BRRD Preamble, recital 45 and Art. 32(5). Recital 45 BRRD: A failing institution should in principle be liquidated under normal insolvency proceedings. However, liquidation under normal insolvency proceedings might jeopardise financial stability, interrupt the provision of critical functions, and affect the protection of depositors. In such a case it is highly likely that there would be a public interest in placing the institution under resolution and applying resolution tools rather than resorting to normal insolvency proceedings. And see, for further analysis, J-H Binder, 'Proportionality at the Resolution Stage: Calibration of Resolution Procedures and the Public Interest Test' Working Paper 3 July 2017, <https://ssrn.com/abstract=2990379>.

(2018) and Nieto (2016) defend the need to harmonize and ultimately unify bank insolvency law in the banking union.⁵

This paper analyses the EU and US approaches to bank insolvency and reflects on the effectiveness of insolvency procedures for banks (and their holding companies in the United States), as well as on the advantages and disadvantages of a dual system that includes an administrative authority and court-based procedures. The paper also analyses the need for coordination through harmonization in the EU, and especially in the euro area, and the need for enhanced substantive coordination with a view to development of the European Deposit Insurance System (EDIS).

After this introduction, this paper is divided into four sections. Section 2 presents the current state of debate of the EU versus US approaches to bank insolvency. Section 3 analyses the effectiveness of 'dual' administrative and court-based bank liquidation procedures for the purpose of both coordination within the EU and cross-border coordination. Conclusions and policy implications are presented in Section 4.

2. EU versus US approaches to bank insolvency: Current state of debate

In the EU the Commission's communication of October 2010 set out a general programme for a comprehensive EU framework to manage distressed and failing banks.⁶ The Commission envisaged proceeding gradually towards such a regime in three steps. As a first step, a directive establishing a framework for the recovery and resolution of credit institutions and certain investment firms was adopted in June 2014.⁷ Its substantive content envisages an administrative procedure for the recovery and orderly resolution of credit institutions and certain investment firms in EU primary legislation.⁸ It subsequently served as the blueprint for the corresponding arrangements within the European Banking Union for the euro-area countries aimed at internalizing potential negative spillovers of bank resolution, whereby resolution strategy is developed by the Single Resolution Board (SRB) and executed by national resolution authorities in the Single Resolution Mechanism.⁹

⁵ Bénassy-Quéré, Brunnermeier, Enderlain, Farhi, Fratscher, Fuest, Gourinchas, Martin, Pisani-Ferry, Schnabel, Veron, Weder Di Mauro, and Zettelmeyer (2018) 'Reconciling Risk Sharing with Market Discipline: A Constructive Approach to Euro Area Reform' Center for European Policy Research Policy Insight No 91, January. MJ Nieto, Bank Resolution and Mutualization in the Euro Area (2016), *European Economy Banks, Regulation, and the Real Sector*, 2016.2, pp131-154

⁶ DG Internal Market and Services Working Document 'Technical Details of a Possible EU Framework for Bank Recovery and Resolution' October 2010.

⁷ Council Directive 2014/59/EU of 15 May 2014 on establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU, and 2013/36/EU, and Regulations (EU) No. 1093/2010 and (EU) No. 648/2012, of the European Parliament and of the Council Text with EEA relevance, OJ L 173, 12 June 2014.

⁸ BRRD Recital 15, Art. 3.

⁹ Regulation 806/2014 of the European Parliament and the Council of 15 July 2014 establishing uniform rules and uniform procedure for the resolution of credit institutions and certain investment firms in the framework

In the euro area, in the case of financial institutions subject to the SRB's jurisdiction, the BRRD measures override any national parallel regime. Thus irrespective of whether or not the national regime was invoked prior to the SRB initiation of its plan, the SRB's plan takes precedence. For this purpose, resolution authorities will only have recourse to the BRRD transposition laws, which apply to the entire EU. The initiation of insolvency procedures for banks inside the scope of the Single Supervisory Mechanism (SSM) is reserved to the European Central Bank (ECB), which makes the assessment of 'failing or likely to fail' after consulting the SRB.¹⁰ After this assessment the ECB informs the SRB, which then assesses whether the conditions for a resolution action in relation to the bank are met. If the bank is considered of no 'public interest', the bank will be wound up under the national insolvency procedures. For the purposes of the public interest test, the 'systemic importance' and 'substitutability' of a bank's functions and core business lines need to be taken into consideration to determine their critical importance. This is assessed by considering the bank's function in terms of size of market share, domestic and/or cross-border exposures, level of interconnectedness, complexity of the function, and the degree to which the function is less likely to be substitutable in view of the number of competitors in the market. Given these criteria, the European Banking Authority (EBA) noted that some national authorities simply assume all banks taking deposits are considered to provide critical functions, but this is arguably not the case once more granular criteria are applied.¹¹ The SRB monitors the insolvency procedure of the bank and the deposit insurance scheme efforts to collect on the deposit claims to which it subrogated.¹²

The 'public interest' test opens the door for degrees of discretion and inconsistency of approach in regard to the application of national bankruptcy proceedings for banks which would not qualify for resolution. It is worth noting that, in the absence of any EU-wide harmonization of relevant laws, this discretion extends beyond technicalities (the choice of legal instruments and the allocation of resolution powers to courts or administrative bodies) and includes the definition of underlying policy objectives regarding the ranking of claims, creditors' procedural rights, and, most fundamentally, the role of the state in the funding of liquidation and/or restructuring. Also, set-off and collateral arrangements are minimally harmonized by the Financial Collateral Directive.¹³ The

of a Single Resolution Mechanism and a Single Resolution Fund amending Regulation (EU) No 1093/2010 (L225 20.7.2014).

¹⁰ Article 18(1) subparagraph 2 of Regulation (EU) 806/2014. The circumstances for the assessment of 'failing or likely to fail' are established in Article 18(4) of Regulation (EU) 806/2014.

¹¹ BRRD Recital 9; EBA Report, Recovery Planning: Comparative Report on the Approach to Determining Critical Functions and Core Business Lines in Recovery Plans, 6 March 2015; for discussion see D Singh, Recovery and Resolution Planning: Reconfiguring Financial Regulation and Supervision in J-H Binder and D Singh, *Bank Resolution: The European Regime* (OUP, 2016) at paras 1.30–1.32.

¹² Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) 806/2014 in order to establish a European Deposit Insurance Scheme. COM (2015)686 final. 2015/0270 (COD). Strasbourg 24.11.2015 (Article 41q).

¹³ Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements (OJ L 168, 27.6.2002, 43); amended by Directive 2009/44/EC of the European Parliament and of the Council of 6 May 2009 L 146 37 10.6.2009; and Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 L 173 190

resulting ‘landscape’ of bank insolvency laws across Europe is highly diverse, as national approaches have varied considerably not just on the extent to which courts are involved in case management but also in terms of the applicable substantive laws.¹⁴

For banks that fail to satisfy the ‘public interest’ test as a precondition for application of the resolution tools contained in the BRRD,¹⁵ European legislation has no provisions that can be applied. Other than the Reorganization and Winding-up Directive of 2001, which provides for conflict-of-laws provisions applicable to banks, there is no substantive harmonization of national insolvency procedures.¹⁶ The Winding-up Directive contains principles of universality (all the bankrupt bank’s assets and the claims against these assets are treated equally regardless of their location; Articles 3(1) and 9(1)) and unity (single set of proceedings covering both the insolvent bank’s head office and its foreign branches in the EU; Article 7). These were introduced by ascribing exclusive jurisdiction to home-country resolution authorities and courts.¹⁷ This reflects a lack of political consensus on procedures and institutional arrangements for the management of bank insolvencies among member states. To date no attempt has been made to provide for respective substantive harmonization.¹⁸ Figure 1 shows the different approaches to resolution and liquidation in the US and the EU.

The Commission’s plan to examine the need for further harmonization of bank insolvency regimes was not followed through. Although corporate insolvency was revisited in the context of the European Council initiative to launch a Capital Market Union complementary to bank financing in June 2015, the assessment relating to bank insolvency law is limited.¹⁹ The EU Regulation on insolvency shifts focus away from liquidation and towards helping businesses overcome financial

¹⁴ For example, in Slovenia, Banka Slovenije is the competent authority for the implementation of compulsory liquidation proceedings for banks and has the competence to initiate bankruptcy proceedings in relation to a bank with the relevant court. The aim of compulsory liquidation proceedings initiated by Banka Slovenije is to conclude the bank’s operations and repay the bank’s obligations *vis-à-vis* depositors.

¹⁵ Pursuant to Article 32(1)(c) BRRD (Article 18(1)(c) SRM Reg), resolution actions are permissible only where they can be established to be in the public interest, which, pursuant to Article 32(5) BRRD (Article 18(5) SRM Reg) is the case ‘if it is necessary for the achievement of and is proportionate to one or more of the resolution objectives referred to in Article 31 *and winding up of the institution under normal insolvency proceedings would not meet those resolution objectives to the same extent*’ (emphasis added).

¹⁶ Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganisation and winding up of credit institutions.

¹⁷ Such principles were enshrined in Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganisation and winding up of credit institutions (OJ L 125, 5.5.2001). Note that financial institutions were excluded from the regulation harmonizing collective insolvency proceedings which entail the partial or total divestment of a debtor and the appointment of a liquidator. Council Regulation (EC) No 1346/2000 of 29 May, 2000 (OJ L 160, 30.6.2000).

¹⁸ GG Garcia, RM Lastra, and MJ Nieto, Bankruptcy and Reorganization Procedures for Cross-border Banks in the EU: Towards an Integrated Approach to the Reform of the EU Safety Net, J Fin Reg and Compliance 17(3), 2009, 240–276.

¹⁹ Council of the European Union, *Draft Council Conclusions on a CMU*, ECOFIN 473, Brussels 16 June 2015; D Valiante, Study: Harmonising Insolvency Laws in the Euro Area: Rationale, Stock-taking and Challenges. What Role for the Eurogroup? ECON PE 574.428.

difficulties, and all the while protecting creditors' right to get their money back.²⁰ Speed, cost effectiveness, and predictability are of the essence for efficient national corporate insolvency regimes, along with clear rules on cross-border insolvency. The regulation has within its scope small and medium-sized companies with simple creditor structures. It provides for less court involvement and significantly restricts creditor rights. In sum, the Commission's plans focus on corporate insolvency frameworks, which may facilitate the reduction of the volume of a bank's non-performing loans and eventually the need to liquidate the bank. However, the harmonization of the bank liquidation regime is left intentionally out of scope.

The recent EU Directive that harmonizes the ranking of unsecured debt instruments in the bank insolvency hierarchy is an important step not only to facilitate the application of bail-in.²¹ This development should be contextualized in the concurrent development of the principle of 'no creditor worse off than in insolvency', which means that no creditor should be left worse off in the resolution than in a hypothetical insolvency scenario. It requires that the basic rights of creditors are observed by ensuring the continuation of some types of contract (secured liabilities) and constrains the impact of a potential bail-in from disproportionately affecting certain creditors (non-insured depositors). Most importantly for the purposes of our analysis, such harmonization contributes to the alignment of creditors' hierarchy in both resolution and liquidation. This reduces inconsistent practices across member states in likely demands for liquidity and loss coverage on national deposit guarantee schemes Deposit Guarantee Schemes (DGSs) and aligns incentives for future mutualization of national DGSs in the EDIS.²²

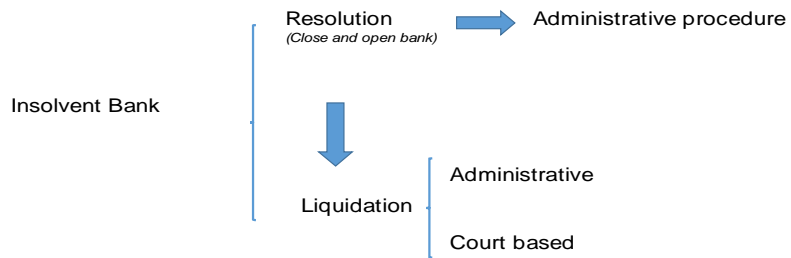
²⁰ Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings (L 141/19, 5.6.2015) (Recast), Recital 10. As a next step, the EU is leading an insolvency initiative that would allow viable businesses in distress to be rescued and honest but bankrupt individuals to be given a second chance: Proposal for a Directive of the European Parliament and of the Council on preventive restructuring frameworks, second chances, and measures to increase the efficiency of restructuring, insolvency, and discharge procedures and amending Directive 2012/30/EU. COM (2016) 723Final. 2016/0359 (COD) Strasbourg 22.11.2016. With the aim of reducing the level of banks' non-performing loans (NPLs), in March 2018 the European Commission presented a package of measures to address the risks related to high levels of NPLs in Europe. The package includes a proposal for a directive on credit servicers, credit purchasers, and the recovery of collateral, a proposal for a regulation amending the capital requirements regulation, and a blueprint for the set-up of national asset management companies (see https://ec.europa.eu/info/publications/180314-proposal-non-performing-loans_en).

²¹ Directive (EU) 2017/2399 of the European Parliament and of the Council of 12 December 2017 amending Directive 2014/59/EU as regards the ranking of unsecured debt instruments in insolvency hierarchy (L347/96, 27.12.2017).

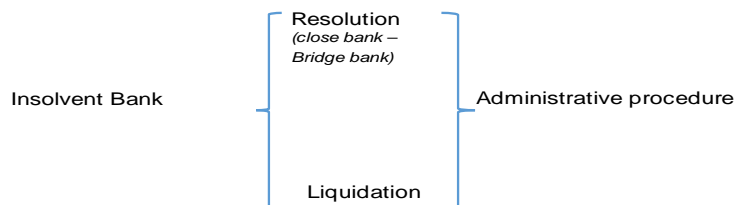
²² MJ Nieto (2016), Bank Resolution and Mutualization in the Euro Area, *European Economy Banks, Regulation, and the Real Sector*, 2016.2, pp131-154.

Figure 1: Bank insolvency management

Panel I: EU



Panel II: US



In the US, the legislative responses to the financial crisis did not significantly affect the Federal Deposit Insurance Corporation's (FDIC) long-standing authority to resolve insured depository banks under the Federal Deposit Insurance Act (FDIA), other than to eliminate any option of open bank assistance and to constrain the FDIC's ability to guarantee debt offerings used in the Temporary Liquidity Guarantee Program. Since 2007 the FDIC has dealt with 531 bank closures, which resulted in loss rates between 4.9 per cent (2007) and 21.7 per cent (2017) of banks' total assets. The broad flexibility to design the 'least costly' resolution approach or to implement a 'systemic risk' resolution for an insured depository bank did not change. Figure 1 shows differences between bank resolution and liquidation management in the EU and the US.

The adoption of the Dodd-Frank Act 2010 created an optional dual resolution framework for non-bank financial companies (such as bank holding companies or broker dealers) that combined a strong preference for the judicial insolvency framework provided by the US Bankruptcy Code with the option to resolve financial companies that pose systemic risks under the separate administrative process provided by Title II (Orderly Liquidation Authority) of the Dodd-Frank Act. It can be argued that this new hybrid resolution framework remains controversial. The election of President Trump, along with control of both Houses of Congress by the Republican Party, led many to fear that the Orderly Liquidation Authority (OLA) might be repealed. While there is always a risk given the sharp political divides now in the US, the threat of repeal has now receded.

On 21 February 2018 the US Treasury Department released its long-awaited report on OLA. The report, 'Orderly Liquidation Authority and Bankruptcy Reform' (the Report), recommends retaining OLA and adopting a new Chapter 14 of the US Bankruptcy Code (the Code) to make resorting to OLA proceedings less likely. In the Report, Treasury ultimately proposed only modest changes to OLA designed to clarify treatment of creditors, tighten the terms for funding from the Orderly Liquidation Fund (OLF) line of credit from Treasury, and strengthen judicial review of the decision to initiate OLA.

The new proposed Chapter 14, which has been developed over several years and has been the subject of several legislative proposals, would include many of OLA's powers, such as a bridge company and temporary stays on termination of qualified financial contracts (QFCs). A broad consensus within the US supports Chapter 14 as reasonable improvements in the capabilities of the Bankruptcy Code process for resolution of financial companies. The Report recommends that Chapter 14 only apply to financial company insolvencies that potentially could create some systemic risks. The goal of reducing the need to resort to OLA is clear.

However, Treasury's recommendations would leave OLA intact. The Report addressed specific criticisms of OLA but did not significantly alter the powers to resolve a systemically important financial institution. Treasury concluded that OLA was necessary as a backstop to bankruptcy in extraordinary cases where private financing is unavailable and to reduce the potential for foreign regulators to ring-fence the foreign operations of Systemically Important Financial Institutions (SIFIs). Treasury recognized the value of OLA both to serve as a back-up process and also to provide an improved environment for international engagement. After all, OLA embodies the main elements of the FSB's 'key attributes'. Of course, the ultimate fate of OLA will be determined through the

political process, but it is safe to say that the value it provides as an optional insolvency process is more broadly recognized than in the past.

It is important to remember that there have been no proposals to repeal the pre-Dodd-Frank Act authority for the FDIC to act as receiver for failed insured banks. There have been occasional proposals to restrict the FDIC's authority to apply its 'systemic risk' exception, but material changes in this authority also appear unlikely.²³

Annex I presents detailed information of the basic characteristics of bank liquidation procedures in the US, Germany, the UK, and Spain. Differences exist in the management of the liquidation process between the US and the EU countries (Germany, the UK, and Spain), and even among these three EU countries differences exist on who decides to initiate bank liquidation, who manages the moratorium, and, at the time of writing, who prioritizes claims. Such differences seem to explain, at least partly, the differences in loss rates of bank liquidation, which are generally smaller in the US (maximum of 21.7 per cent of total assets). Anecdotal evidence from Germany shows that the different DGS, as creditors in the insolvency procedure, experienced loss rates of approximately 32.5 per cent during the period 1995 to 2008; similar evidence from the UK shows that its DGS experienced loss rates of approximately 36.6 per cent in a very recent bank liquidation.

Table 2 summarizes the most relevant characteristics of the institutional frameworks for bank resolution and bank liquidation in selected countries, including the US. Table 3 presents a summary of those characteristics for Germany, the UK, and Spain.

3. *Lex generalis, lex specialis*, and hybrid approaches to banks' bankruptcy: Some reflections

The fact that different jurisdictions have gone their respective idiosyncratic ways in the development of bank insolvency procedures for non-systemically important institutions clearly warrants some caution when approaching the question of 'what works best'. This view is reinforced by a number of comparative studies of different bank insolvency regimes conducted at the beginning of the 2000s, partly in academic research²⁴ and partly arising out of international financial

²³ The Systemic risk exception applies when the FDIC wants to resolve a bank in a way that protects otherwise uninsured creditors of the bank at the expense of the insurance fund. This requires political approval. The FDIC is not required to obtain political approval for resolutions that are in accord with the least cost. See proposed changes in the Financial Choice Act, §242. More limited legislation was introduced into the Senate by the outgoing chairman of the Senate Banking Committee, Richard Shelby. It is unclear whether these issues will be a focus for new Senate Banking Committee Chairman Crapo or whether the new president will push for repeal of the OLA.

²⁴ See EHG Hüpkens, *The Legal Aspect of Bank Insolvency* (Kluwer 2000), 49–106; and see, for a functional comparison of the pre-crisis approaches in Germany and the UK, Binder, *Bankeninsolvenzen im Spannungsfeld zwischen Bankaufsichts- und Insolvenzrecht* (Duncker & Humblot 2005); RM Lastra and HN Schiffman, *Bank Failures and Bank Insolvency Law in Economies in Transition* (Kluwer Law International 1999); A Campbell and P Cartwright, *Banks in Crisis: The Legal Response* (Ashgate 2002).

institutions and standard-setting bodies.²⁵ Quite in line with the pre-crisis consensus (or, rather, lack of consensus),²⁶ in a survey of national approaches across a wide range of jurisdictions published as part of their Global Bank Insolvency Initiative at the beginning of the 2000s, the IMF and the World Bank expressly recognized the conceptual validity of different institutional approaches, subject to certain functional conditions that may or may not be in place in a system.²⁷ To complicate things even further, the above analysis of different jurisdictions (just as the pre-crisis comparative literature) also demonstrates that the policy choice is not confined to a rather simple *lex specialis*, *lex generalis* dichotomy. As evidenced in particular by the examples of Spain and Germany, the combination of administrative procedures *and* court-based case management provides legal certainty but does not always result in minimal total costs (see Annex 1).

The financial crisis has highlighted the need to strengthen early intervention measures by supervisors, irrespective of whether the bank crisis is dealt with through administrative resolution procedures or court-based liquidation (or a combination of the two). Such early intervention measures may include requests to raise funds by bank shareholders and bank recovery plans which envisage liquidation of banks (or parts of banks) with no 'public interest'. In the aftermath of the financial crisis, we also observe the convergence of restructuring tools used in bank insolvency and bank resolution; for example, the same priority of claims when absorbing losses.

In the EU the bank crisis management framework designed in 2010 aimed at ensuring that if the problems of an institution are irreversible and there is no private or supervisory solution, recovery and resolution of the ailing entity are not the only, or even the preferable, option for the authorities. Accordingly, the Commission's view is that the general rule should be that failing credit institutions should be liquidated under ordinary insolvency proceedings.²⁸ Only when this is not feasible will resolution using the alternative tools provided by the BRRD be necessary, for reasons of financial stability: to minimize contagion, ensure continuity of vital economic functions, maximize the value of remaining assets, and facilitate the return of the restructured bank to the private sector. In any form of liquidation, the insolvent bank essentially disappears in full or in part. In this context, 'significance' of the relevant institution in terms of the scope of the SSM does not necessarily mean that the institution will be considered in need of resolution under the BRRD (see Table 3). For example, in June 2017 the SRB decided that Banca Popolare di Vicenza SpA and Veneto Banca SpA, deemed significant banks (based on total assets between (€30–50 billion) by the ECB,²⁹ had not met

²⁵ See MC Asser, *Legal Aspects of Regulatory Treatment of Banks in Distress* (IMF 2001); M Giovanoli and G Heinrich (eds), *International Bank Insolvencies: A Central Bank Perspective* (Kluwer 1999).

²⁶ RM Lastra (ed), *Cross-border Bank Insolvency* (OUP 2011).

²⁷ IMF and World Bank, 'An Overview of the Legal, Institutional, and Regulatory Framework for Bank Insolvency' 17 April 2009, <https://www.imf.org/external/np/pp/eng/2009/041709.pdf> at paras 17–20.

²⁸ See also Article 32(5) BRRD, which explicitly implements this notion as part of the 'public interest' test (supra, text and n. [xxx]). And see, to the same effect, BRRD, preamble, indent 46, stating that 'The winding up of a failing institution through normal insolvency proceedings should always be considered before resolution tools are applied.'

²⁹ The Single Supervisory Mechanism definition of significant bank includes the three largest banks of the participating member states, which may or not be systemic.

the conditions for a resolution action, and as a consequence the winding up of these banks did take place under national proceedings launched by the Italian authorities.³⁰ The two banks were not listed as Other Systemically Important Institutions (O-SII's) by the national designated authorities for the purposes of capital buffers in line with Capital Requirements Directive (CRD IV) (which are applied when the institutions are deemed to be providing critical functions in their respective markets and so in view of their importance are considered to be a potential risk to financial stability). Similarly, the most recent decision by the SRB regarding ABLV bank,³¹ a significant bank in Latvia (based on it being one of the three largest banks), did not consider the bank to undertake critical functions for the purposes of resolution, although it had been categorized by the Financial and Capital Market Commission of Latvia as an Other Systemically Important Institution for the purposes of capital buffers.³² Likewise, the subsidiary of ABLV in Luxembourg (not listed as an Other Systemically Important Institution in Luxembourg) was also deemed to be failing as a consequence of the winding up of the parent bank but did not enter resolution under the BRRD.³³ The SRB conclusion that it did not provide critical functions to the real economy needed to be explained with reference to the fact that ABLV's principal business was with non-resident depositors. Moreover, the reasons for ABLV failing, as an exceptional case, should have led to both the ECB and SRB to explain the implicit importance of safeguarding market integrity as well as financial stability in their decision notices as well.³⁴

These cases highlight the need for reform to improve consistency and predictability of outcomes at the insolvency stage and minimize the risk of moral hazard ensuing in the bank sector. At this juncture it is too early to say that the decision on critical functions to classify a bank by the national designated authority as an O-SII is correlated to the resolution authority decision to take either resolution or insolvency when a bank is failing or likely to fail. The fact that the majority of Eurozone banks are less significant and Eurozone significant banks have been (and will likely be) placed in liquidation as oppose resolution. The political assumptions of the majority of banks are likely to move into resolution rather than liquidation has not materialized and so leads to a greater argument

³⁰ See <https://srb.europa.eu/en/node/341>.

³¹ Notice summarizing the decision taken in respect of ABLV Bank, AS
https://srb.europa.eu/sites/srbsite/files/20180223-summary_decision_-_latvia.pdf.

³² https://www.esrb.europa.eu/pub/pdf/other/20161003_notification_capital_market_commission_latvia.en.pdf?98026a22b2cbe1813250c678cbb265a

³³ https://srb.europa.eu/sites/srbsite/files/20180223_summary-decision_-_luxembourg.pdf.

The Single Resolution Board does not take resolution action in relation to ABLV Bank, AS and its subsidiary ABLV Bank Luxembourg S.A., 24 February 2018; see further US Department of the Treasury, FinCEN Names ABLV Bank of Latvia an Institution of Primary Money Laundering Concern and Proposes Section 311 Special Measure, <https://www.fincen.gov/news/news-releases/fincen-names-ablv-bank-latvia-institution-primary-money-laundering-concern>; Department of the Treasury, Financial Crimes Enforcement Network 31 CFR Part 1010 RIN 1506-AB39 Proposal of Special Measure Against ABLV Bank, AS as a Financial Institution of Primary Money Laundering Concern https://www.fincen.gov/sites/default/files/federal_register_notices/2018-02-16/2018-03214.pdf.

³⁴ Hence the asterisk in Table 1.

for common insolvency-liquidation proceedings. Thus there is a need for a clear perimeter as to what bank insolvency proceedings should aim to achieve in such circumstances when safeguarding the portfolio of deposit-taking accounts in a timely manner and the interests of the deposit protection fund. However, the misalignment between resolution and liquidation proceedings highlights the ability of national authorities to exercise idiosyncratic liquidation processes.

Against this background, the question remains of whether a dual-system liquidation procedure (administrative and court based) yields the optimal trade-off between legal certainty and cost effectiveness.

3.1 Could a dual system be effective in the EU?

As essentially all traditional pre-crisis means of bank insolvency procedures, be they part of general insolvency law or based in special banking legislation, included a moratorium or similar means to trigger the breakdown of contractual and economic relationships between a failing institution and its counterparties, it should not come as a surprise that bank insolvency management, prior to the implementation of modern BRRD-style resolution, was usually geared to liquidation. The modern concept of 'resolution', against this backdrop, is an alternative whose primary objective consists in avoiding the breakdown of critically important relationships in the interest of systemic stability, and which evolved in parallel to the development of large systemic international banks and highly interconnected money and capital markets.³⁵

While the BRRD itself distinguishes only between 'resolution' (the application of a resolution tool to accomplish a resolution objective) on the one hand and 'winding up' on the other, the analysis of different jurisdictions has demonstrated that there is no such thing as a universal, or even a Europe-wide, agreed concept of what a winding up of a credit institution is, or, indeed, how it should be accomplished. As aptly illustrated by the pre-crisis discussion on different national approaches to bank insolvency management below the threshold of systemic relevance (leaving aside, for a moment, how and by whom this threshold would have to be defined in specific cases), consensus as to the relevant policy choices does not exist. Moreover, how the threshold of systemic relevance would be defined in specific cases is open to question. In the context of the SSM, the ECB deemed Veneto Banca and Banca Popolare di Vicenza as significant institutions.

The lack of consensus is not just with regard to the substantive design of bank insolvency procedures, namely the definition of objectives to be pursued (restructuring and/or liquidation), the powers of relevant actors (administrative authorities, courts, liquidators, creditors' meetings or committees), the substantive rights allocated to stakeholders (e.g. the ranking of claims, recognition or non-recognition of collateral arrangements, set-off rights, etc.), and the availability of legal redress. At the institutional level, the lack of an EU approach also holds true for the fundamental choice

³⁵ See Binder, 'Resolution: Concepts, Requirements, Tools', in J-H Binder and D Singh, *Bank Resolution: The European Regime* (OUP, 2016), paras 2.14–2.25.

between administrative and court-based procedures. In the aftermath of the financial crisis, it appears that national approaches have been developed path-dependently, but – at least in jurisdictions with relevant experience of bank failures in the past (like Germany and Spain) – broadly compatible with national market structures and endogenous parameters, like the capability and reliability of the general insolvency courts. Good examples of that can be found in the cases of Germany and Spain, where a mistrust in the capacity of general insolvency courts to attain swift, effective control of an ailing institution in the early stages of the crisis led to the monopolization of case management within the hands of the supervisory authority, and in the case of the UK, where smaller banks were resolved under general insolvency law without causing major concerns prior to the global financial crisis.³⁶

In this light, the question of whether a ‘dualistic’ concept of bank insolvency management can work reliably must be restated. Given the residual multitude of different national approaches to dealing with failing banks below the ‘public interest’ threshold defined in Article 32(5) of the BRRD, euro area banks whose insured depositors are covered by national DGSs are expected to be mutualized in the context of the EDIS.³⁷ The first question to be addressed is whether there is a need for greater harmonization in substantive terms, and whether this should entail a full harmonization of policy objectives, procedural powers, substantive rights of stakeholders and so forth, or merely adjustments with regard to certain technical features, such as the insolvency ranking of creditors at least in the euro area. Related to all this, again, is the design of the relevant institutional set-up, including the fundamental policy choice between administrative and court-based case management.

If one accepts only the systemic relevance of the relevant institution or the systemic impact as the key determinant for the fundamental choice between alternative ‘resolution’ (as prescribed by the BRRD) on the one hand and liquidation in more traditional ways on the other, the first question turns out to be far more complex than could be expected at first sight. If a failing bank is not systemically important, in the sense that its (more or less) orderly exit from trading does not pose substantial threats to other market participants, clients, and market infrastructure within its domestic environment, let alone beyond its borders, the need for a harmonized, pan-European regime demands a careful assessment of cost and benefits undertaken during a robust resolution planning process. Indeed, some would argue that any attempt to prescribe a comprehensive concept in EU law, including full harmonization of both substantive law and institutional responsibilities, might risk ignoring national market infrastructures and the characteristics of national administrative and court infrastructures. If, for example, European law were to impose the duty to establish a fully harmonized *lex specialis* approach, with the initiation and management of cases entrusted exclusively to administrative resolution authorities, the benefits of such an approach in terms of minimization of losses and distribution of losses among creditors need to be

³⁶ Campbell and Cartwright, (n 24).

³⁷ The EDIS will provide the respective national DGS with the funds it needs to meet its funding obligations if there is a payout event and/or DGS needs to contribute to a bank resolution. The payout event could be the result of a ‘liquidity shortfall’ or a ‘loss cover’ of the participating DGS. Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) 806/2014 in order to establish a European Deposit Insurance Scheme. COM (2015)686 final. 2015/0270 (COD). Strasbourg 24.11.2015 (Article 41q).

assessed against the cost of stakeholders in jurisdictions with court-based or hybrid systems, who may initially find themselves in a much worse position than before, even though public interest concerns hardly require their interests to be set aside in such cases. If, by contrast (less likely), European law were to prescribe the duty to implement a *lex generalis* approach whereby all cases below the 'public interest' threshold would be subject to general insolvency law and be resolved through court-based insolvency procedures, this could simply reduce the effectiveness of residual arrangements in jurisdictions where insolvency courts cannot be relied upon to deliver adequate solutions.

The option of resolution or insolvency liquidation and the importance of the integrity of the decision once a bank is failing are highlighted in different parts of the paper. The independence of either the judiciary or administrative agency is crucial to ensure the integrity of the decision and minimize the risk of it being influenced by political considerations. The need to structure administrative discretion with rules and principles has been an important way of minimizing the risks of forbearance and safeguarding private rights. This dualist approach will need the appropriate safeguards to ensure review of decisions at critical junctures to oversee their integrity and consistency of practice. To be sure, these considerations should not be read as providing unreserved support for the preservation of the *status quo* either. Even if the residual arrangements for bank insolvency management in all Member States were to be found adequate in terms of the objective of minimizing losses while preserving financial stability, the disparity of national regimes for dealing with banks' bankruptcy within the EU could have a material impact on the financial position of national DGSs. Against this backdrop, further harmonization would be particularly desirable, firstly in the definition of 'public interest' and in the insolvency ranking of holders of debt instruments and the legal certainty that creditors face. The 'public interest' test as defined by Article 32(5) of the BRRD is by no means a clear-cut definition between the scope of BRRD-style resolution on the one hand and 'winding up' as prescribed by the respective national regimes on the other. In many respects, legal certainty for both the institutions and their stakeholders seems to require a much clearer definition of the underlying perimeter – something that the existing guidance provided by the EBA does not seem to provide.³⁸ This would seem particularly problematic in cross-border cases, where the decisions made by home-country authorities and courts are to be recognized automatically across the EU as a result of the 2001 Winding-up Directive,³⁹ in the case of branches. However, within the Banking Union such concerns are, for the purpose of bank resolution, mitigated through the centralization of decision-making procedures within the SSM and SRB.

³⁸ EBA Guidelines on the application of simplified obligations under Article 4(5) of Directive 2014/59/EU. EBA/GL/2015/16 of July 2015. The EBA has specified mandatory and optional indicators for the criteria provided in Directive 2014/59/EU, while providing NCAs with the discretion with regard to the methodology for assessment and the related review process.

³⁹ Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganization and winding up of credit institutions (OJ L 125, 5.5.2001). Note that financial institutions were excluded from the regulation harmonizing collective insolvency proceedings which entail the partial or total divestment of a debtor and the appointment of a liquidator. Council Regulation (EC) No 1346/2000 of 29 May 2000 (OJ L 160 30.6.2000). See for further discussion in this regard J-H Binder, Cross-border Coordination of Bank Resolution within the EU: All Problems Resolved? ECFR (2016), at 575, 584–85.

Secondly, country differences to the statutory insolvency ranking of bank creditors impacts the levels at which impairments affect claims, providing uncertainty for investors. Directive (EU) 2017/2399 harmonizes the ranking of unsecured debt instruments in insolvency hierarchy. The general insolvency preference for certain uninsured depositors' claims prescribed by that provision will be complemented by a new designated ranking position for holders of 'non-preferred' debt instruments issued by credit institutions, which would receive payments only after the claims of other creditors have been met in full. The new Directive seeks to balance out existing national differences in the treatment of subordinated debt instruments in bank insolvency, which in turn have a significant impact on the economic outcomes of bank restructuring or liquidation under either the BRRD 'resolution' framework or the applicable national bank insolvency laws. However, it does not go as far as the ECB suggestion, and the 2017 Directive (new Article 108) does not incorporate a general depositor preference rule based on a tiered approach.⁴⁰ This would have improved application of the bail-in tool even further by enhancing 'resolvability by clarifying the hierarchy of creditors and facilitating the allocation of losses to unsecured bank debt instruments ahead of certain operational liabilities, while alleviating concerns regarding the "no creditor worse off than under normal insolvency proceedings" principle'.⁴¹ Moreover, a general depositor preference rule with a tiered approach would allow equal protection of insured depositors throughout the euro area, even in crisis-struck countries. In turn, this is consistent with the credibility of the euro.⁴²

Other differences in the hierarchy of claims in a bank insolvency are still not harmonized, for example with regard to the treatment of intragroup liabilities and the subordination of different forms of liabilities.

The common EDIS, if adopted as proposed, will provide the respective national DGS with the funds it needs to meet its reimbursement obligations if there is a payout event⁴³ and/or the DGS needs to contribute to a bank resolution.⁴⁴ The existing proposals provide for progressive mutualization of contributions and an increase in the share of depositor payouts, which will be funded by EDIS; first as a reinsurer providing liquidity coverage, and, subject to certain conditions, as a coinsurer

⁴⁰ ECB, Opinion of the European Central Bank of 8 March 2017 on a proposal for a directive of the European Parliament and of the Council amending Directive 2014/59/EU as regards the ranking of unsecured debt instruments in insolvency hierarchy (CON/2017/6), OJ C 132/1 of 26 April 2017, paras 1.2–1.4; see 2017/2399 Recital 16.

⁴¹ *ibid* ECB, para 1.4.

⁴² See AM Bénassy-Quéré, M Brunnermeier, H Enderlein, E Farhi, M Fratzscher, C Fuest, PO Gourinchas, P Martin, J Pisani-Ferry, H Rey, I Schnabel, N Véron, B Weder di Mauro and J. Zettelmeyer, *Reconciling risk sharing with market discipline: A constructive approach to euro area reform*, CEPR Policy Insight No. 91, Centre for Economic Policy Research, London, (2018).

⁴³ The payout event could be the result of a 'liquidity shortfall' or a 'loss cover' of the participating DGS.

⁴⁴ When using resolution tools (bail-in) for the amount of losses that covered depositors would have suffered if they had suffered losses in proportion to those suffered by creditors with the same level of priority (i.e. unsecured debt) under normal insolvency procedures. The liability of the DGS shall not exceed the losses it would have incurred under normal insolvency.

providing loss coverage to a national DGS. EDIS will be an insurance fund on which insured depositors of the euro area banks and other participating countries in the Banking Union will have a full claim.⁴⁵ Disparity of national regimes for dealing with banks' liquidation within the euro area (and future participating members of the Banking Union) may result in national differences in bank losses and the levels at which impairments affect claims having a material impact on the financial position of national DGSs and EDIS.⁴⁶ To take an example from Germany: cooperative banks as well as state-owned Landesbanks and savings banks owned by local councils have traditionally been organized in networks that, in the event of a failure, would not pay out insured deposits but rather facilitate and fund the restructuring of the insolvent business, mostly in the form of an assisted merger with other institutions within the same network (*Institutssicherung*: protection of institutions rather than protection of deposits).⁴⁷ While these arrangements are compatible with general EU law requirements on deposit guarantee schemes, they would be difficult to integrate within EDIS.

It seems evident that fair, commonly accepted burden-sharing arrangements in cross-border scenarios – in the form of EDIS or otherwise – are inconceivable without further harmonization of bank insolvency legislation within the EU as a whole and the Banking Union in particular. In this context, it is important to distinguish between *substantive* law – including, in particular, the full harmonization of creditors' rights and the hierarchy of claims in insolvency law – on the one hand and the institutional and procedural framework for bank liquidation on the other. While the centralization of bank insolvency management could contribute to internalizing the potential negative externalities in bank liquidation and limiting moral hazard,⁴⁸ the harmonization of substantive laws arguably would play an even more important role, as differences in this respect are probably among the most important determinant for inadequate solutions to both national and cross-border scenarios. Suboptimality would result from non-minimization of bank losses. Because EDIS should be implemented in a way that unambiguously creates equal protection for all insured euro area depositors, some argue namely, Bénassy-Quéré et al.,⁴⁹ the pricing of country-specific

⁴⁵ Communication to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions on completing the Banking Union. Brussels 11.10.2017. Com (2017) 592 Final.

⁴⁶ The SRB will administer not only the SRF to ensure the effective application of the resolution tools in the context of a bank resolution but also EDIS. See M Nieto (2016), Bank Resolution and Mutualization in the Euro Area in European Economy, Banks, Regulation and the Real Sector 016.2, 131–54, <http://european-economy.eu/leading-articles/bank-resolution-and-mutualization-in-the-euro-area/>.

⁴⁷ Cf: Eva Hupkes, 'Protect functions, not institutions' *The Financial Regulator*, [2004] 43-49.

⁴⁸ A common bank resolution and liquidation authority already exists in some EU countries, such as Slovenia. Law on Financial Operations, Insolvency Proceedings and Compulsory Dissolution (ZFPPIPP) (Ur. l. RS No 13/14 – official consolidated text and 10/15 – corr.)

⁴⁹ AM Bénassy-Quéré, M Brunnermeier, H Enderlein, E Farhi, M Fratzscher, C Fuest, PO Gourinchas, P Martin, J Pisani-Ferry, H Rey, I Schnabel, N Véron, B Weder di Mauro and J. Zettelmeyer, Reconciling risk sharing with market discipline: A constructive approach to euro area reform, CEPR Policy Insight No. 91, Centre for Economic Policy Research, London, (2018)

risk in the calculation of insurance premiums should be based on structural indicators of creditors' rights, such as the effectiveness of insolvency and foreclosure procedures. In addition to the process of stress testing the role of the DGS in bank resolution and insolvency.⁵⁰

3.2 Is the US administrative bank resolution system effective to facilitate international coordination?

The US has long had a dual resolution process for financial companies. FDIC-insured banks are resolved under the FDIA. Non-bank financial companies, such as bank holding companies, were resolved under the Bankruptcy Code, with a few exceptions such as for insurance companies. Today, the FDIA remains the exclusive resolution process for FDIC-insured banks. Dodd-Frank created an optional dual resolution process applicable to large bank holding companies and other financial companies. As a result, conceptually there may be questions about how international coordination can be achieved given the potential application of different resolution proceedings for an FDIC-insured bank and that bank's parent holding company, which may or may not be subject to the FDIC-like and administrative-led liquidation procedure.

The FDIA applies a separate administrative insolvency process for a US-insured bank that, with the cooperation of the host authorities for that bank's foreign branches, can apply to the US domestic and international operations of the bank. In the majority of host jurisdictions there is no required seizure of a foreign bank's branches upon a receivership of the home bank if the home-country authority ensures that the branches meet the host-country requirements for continued operations. In effect, the resolution of a US bank in a cooperative way with host-country supervisors and resolution authorities depends on the willingness of the US FDIC to meet local branch requirements and the willingness of the host authorities to defer immediate action. These requirements, and the comparative incentives of the US and host authorities, have been the subject of extensive discussions over many years, but most specifically since the recent financial crisis.

Since the financial crisis, the uncertainties inherent in a bank-specific insolvency process and in the optional responses of the FDIC and host authorities are the primary reasons for the focus on the resolution of the parent holding company under the single point of entry (SPOE) framework. While an SPOE resolution of the parent holding company does not address the optionality for holding company resolution, it makes that optionality less problematic. It also reflects ambivalence regarding the appropriate role of judicial and administrative insolvency regimes of financial firms. This ambivalence, and the political and policy issues surrounding it, is reflected in the differences between OLA and the proposed Financial Choice Act.

The principal reason why this optionality between resolution under the US Bankruptcy Code or resolution under OLA for SIFIs is not as troublesome today is that the US and other authorities have required large financial institutions to create reservoirs of bail-inable debt to permit the

⁵⁰ EBA, Final Report, Guidelines, on stress tests of deposit guarantee schemes under Directive, 2014/49/EU, 24 May 2016

recapitalization of the holding company. As a result, it can be argued that the SPOE strategy and the specific processes designed to implement it make the insolvency law that might apply less relevant.

This approach to SIFI resolution is fundamentally designed to address the difficulties of international coordination during resolutions by making the resolution of the key subsidiaries unnecessary, and it is conceptually similar to bank resolution in the BRRD.

However, political developments in the US can have a negative impact on progress. While the potential that Congress will repeal the OLA provisions has receded, particularly given Treasury's Report, if it were to do so that action would eliminate the more harmonized insolvency framework that has been constructed internationally. The repeal of OLA would, arguably, call into question US reliability as a partner in improving resolvability. Elimination of the liquidity funding component of OLA – the OLF which provides a limited line of credit from the US Treasury to fund a resolution temporarily – likewise could undermine the US ability to resolve a SIFI that, in a crisis, could not be resolved under the Bankruptcy Code due to the likely absence of sufficient short-term liquidity resources under that law.⁵¹ The OLF – required to be repaid in full by the banking sector and not impose any losses on the taxpayer – may be critical to avoid a disorderly resolution. While a SPOE resolution for a holding company can, in theory, be implemented under the Bankruptcy Code given sufficient total loss-absorbing capacity and liquidity resources, and well-constructed parent–subsidiary recapitalization frameworks, the elimination of the OLA option seems to limit flexibility unduly and potentially increase, rather than decrease, the likelihood of future bail-outs.

Any elimination or major modification of OLA would likely be perceived as a retrenchment by the US from the goal of achieving resolvability for US SIFIs under an administrative procedure – and likely would increase the pressure in host jurisdictions to seek to impose additional constraints (such as more stringent intermediate holding company specifications) and capital and liquidity requirements on US SIFIs so that host countries could, in theory, separately resolve those host-country subsidiaries under the national law. This development – which is already a possibility under the intermediate holding company mandate in the US and the proposed requirement in the EU⁵² – will greatly increase the likelihood that any future resolution of a global SIFI will lead to separate resolutions in the home country and all host countries. Treasury specifically cited the potential responses of other countries in its Report recommending the retention of OLA. Fortunately, the repeal of OLA appears to be substantially less likely today.

4. Conclusions and policy implications

As a response to the financial crisis, European legislators took a number of steps to harmonize insolvency law – a difficult task, not least because of the substantial differences in the regimes and authorities involved. Hence a harmonized administrative crisis management regime for banks in the form of the BRRD was introduced, which is similar to the FDIC administrative liquidation of banks in

⁵¹ Authority to borrow up to US\$500 billion for insurance losses from the US Treasury.

⁵² Proposed Article 21(b) Directive of the European Parliament and of the Council amending Directive 2013/36/EU.

the US. This will contribute to facilitate cross-border resolution of banks that operate across the Atlantic.

In the EU, different national frameworks have been developed to deal with bank liquidation, and have been refined over time in response to the individual characteristics of the respective market structures, administrative (or court) infrastructures, and specific lessons learnt during individual incidents of bank failures. Consequently, although each system will usually be the product of a more or less path-dependent evolution, which may or may not entail the preservation of inefficient procedural or substantive solutions, the diversity of arrangements as such should be expected. In fact, the diversity of banking systems and administrative law traditions seems to explain, at least partly, the diversity of bank liquidation frameworks and the differences in their efficiency measured in terms of loss rates of the respective DGS.

In particular, the diversity of existing approaches to ‘no public interest’ insolvencies creates problems within the euro area and future participating members of the Banking Union for three main reasons. First, increasing integration of the European banking and financial markets almost inevitably means that cross-border implications of a liquidation can, and will, arise even in cases involving small or medium-sized banks (e.g. runs on similar debt types in banks in other countries or simply debt-spread variations due to contagion). In this context, differences in residual national regimes could lead, *inter alia*, to differences in the treatment of creditors (secured or unsecured and even within each class, e.g. intragroup liabilities) and thus to differences in terms of economic outcomes, as well as to legal uncertainty, all of which contradict the very objective of an integrated common market for financial services. Furthermore, in the euro area the credibility of the euro relies on ensuring equal protection of insured depositors throughout the area, even in crisis-struck countries. Secondly, and more specifically, the efficiency of national regimes in dealing with bank insolvency will have an impact on the financial situation of national DGSs on which insured depositors have a claim, creating differences in liquidity and loss coverage needs of national DGSs (e.g. lengthy bankruptcy procedures may result in dramatic deterioration of the banks’ asset recovery values). The pan-European deposit insurance scheme (EDIS), which by definition can arguably be seen as a burden-sharing arrangement based on commonly accepted principles, is hardly conceivable in an environment where differences in national bankruptcy administration and in the substantive treatment of claims in national bankruptcy laws result in substantial differences in terms of the economic value of a given claim against an ailing institution. Thirdly, the inefficiency of bank liquidation procedures to wind up the residual bank within a reasonable timeframe may lead to a decision by the resolution authority not to use the bridge bank resolution tool as a part of a reorganization procedure and avoid a situation of creating a residual bank that would be put in to winding up proceedings.⁵³ Hence the effectiveness of the systemic banks’ resolution procedure

⁵³ BRRD Art. 37(3)-(6). It is worth noting, in this context, that the IMF’s 2018 Financial Stability Assessment expressly recommends to enhance the role of bridge banks as a resolution tool also for systemically important financial institutions. See International Monetary Fund, “Euro Area Policies – Financial Stability Assessment” (27 June 2018), para. 59. See also Jens-Hinrich Binder, “The Relevance of the Resolution Tools Within the SRM”, European Banking Institute Working Paper Series 2018 - no. 29, <https://ssrn.com/abstract=3274520>.

could depend on the harmonization of at least certain substantive aspects of banks' liquidation to the highest standards.

Annex 1: Bank insolvency in the US, Germany, the UK, and Spain: in what circumstances, special provisions for banks apply?

United States

The United States led the discussion during and in the aftermath of the financial crisis by advocating an internationally coordinated approach to resolution. Yet the US had a longstanding history of and extensive experience with bank failures, and was accordingly the first jurisdiction to adopt a comprehensive regime to manage distressed non-bank financial companies to protect financial stability.

The following discussion focuses on the resolution of insured depository banks, and not large, complex holding companies or non-banks. As noted in the introduction, the financial crisis did lead to statutory changes in the US through the Dodd-Frank Act to create an optional resolution process for large financial companies that are not insured depository banks. The Dodd-Frank Act's OLA is designed only for systemically important non-bank financial companies, such as holding companies, when resolution under the normal US Bankruptcy Code would potentially impair financial stability.⁵⁴ This OLA parallels many elements of the FDIA. While consistent with the FSB principles, OLA does include some differences from the BRRD.

The Resolution of FDIC-Insured Banks under the FDIA

Initiation

An FDIC receivership would commence when an insured depository's chartering authority, for example the Office of the Comptroller of the Currency (OCC) or a state banking department, issues an order closing the institution (i.e. revoking its charter to operate as a depository institution) and appointing the FDIC as receiver.⁵⁵ The appropriate federal banking agency, after consultation with the state regulator, may also appoint the FDIC as receiver if a state-chartered depository institution is undercapitalized or critically undercapitalized and it is necessary to fulfil the purposes of the prompt corrective action requirements.⁵⁶

The FDIC has authority to close a bank and appoint itself as its receiver under certain circumstances. The latter option, however, is rarely used; the more common process would be for the bank to be closed by the OCC and for the FDIC to be appointed as the receiver. The OCC and the FDIC have broad discretion to initiate resolution based on numerous grounds, including insolvency, insufficient liquidity, unsafe or unsound condition, and substantial dissipation of assets or earnings. Further,

⁵⁴ Title II of the Dodd-Frank Act establishes a special insolvency regime under OLA for SIFIs, including bank holding companies and non-bank financial companies such as insurance brokers and dealers.

⁵⁵ 12 U.S.C. § 1821(c).

⁵⁶ 12 U.S.C. § 1821(c)(9).

regulators need not wait until the bank is actually insolvent but can initiate resolution if the bank is likely to fail.

To provide additional time to complete a resolution and reduce interruptions in the provision of banking services, banks are generally placed in receivership at the close of business on a Friday, and the FDIC then executes a resolution strategy.

Moratorium

Like OLA, under the FDIA counterparties to qualified financial contracts (QFCs) are stayed from closing out their contracts for one business day, during which time the receiver may transfer QFCs to a bridge financial company or third party.⁵⁷ Counterparties to transferred QFCs are prohibited from closing out based solely on the appointment of a receiver or the transfer of their QFCs. In exercising its power to transfer QFCs, the FDIC as receiver must transfer all contracts between the failed financial company and a counterparty (and all of the counterparty's affiliates), or transfer no such QFCs. In other words, the receiver cannot 'cherry pick' certain QFCs to transfer.

- Management of the insolvency process

The FDIC is granted broad discretion in exercising its authority under the FDIA bank insolvency regime. To ensure that the actions taken by the FDIC to resolve a failed bank are decisive and final, the FDIA limits judicial supervision of FDIC resolutions. The FDIC is granted authority to establish the method by which creditors file claims and to adjudicate the claims submitted. After all administrative procedures have been exhausted, claimants are entitled to de novo review of their claims by a court. The FDIA also restricts the jurisdiction of courts to hear any claim or action for payment from, or any action seeking determination of rights of the assets of, an insured depository institution for which the FDIC has been appointed as a receiver, or any claim related to the acts or omissions of the FDIC or the failed bank. Further, courts are prohibited from attaching or executing on assets. When courts have reviewed the FDIC's actions in connection with bank resolutions, they have tended to enforce the statutory limitations on the courts' jurisdiction and defer to the FDIC's judgement.⁵⁸

Resolutions under the FDIA are funded by the Deposit Insurance Fund (DIF). To preserve the DIF, when resolving a failed bank the FDIC is required to adopt a resolution strategy that resolves the bank (including its subsidiaries) separately from its parent company, and resolves its deposit-taking operations, core business lines, and major assets in a manner that creates the least cost to the DIF of all possible methods for resolving the bank. The FDIC can depart from this requirement only if the 'least costly' resolution would have 'serious adverse effects on economic conditions or financial stability' and an alternative resolution would 'avoid or mitigate such adverse effects'.⁵⁹ Permission to exceed this 'least costly' requirement must be approved by the Secretary of the US Treasury

⁵⁷ See 12 U.S.C. §1821(e)(8).

⁵⁸ 12 U.S.C. §§1821(d) and (e), 1823.

⁵⁹ 12 U.S.C § 1823(c)(4)(G).

following recommendations from a two-thirds majority of the FDIC Board and the Board of Governors of the Federal Reserve System.

Priorities, collateral, and set-off

In general, as receiver the FDIC succeeds to all rights, titles, powers, and privileges of the institution involved and of any stockholder, member, depositor, officer, or director. In an FDIA receivership of the bank, secured creditors would recover to the extent of the collateral. FDIC resolution gives payment priority to depositors, including the FDIC as subrogee, over general unsecured creditors. Therefore, in an FDIC receivership, creditors recover in the following order:

- the receiver for its administrative expenses;
- depositors, including the FDIC as subrogee for insured depositors and uninsured depositors;
- general creditors;
- subordinated corporate debt holders; and
- shareholders.⁶⁰

Secured creditors receive payment through the pledged collateral up to the market value of the collateral and, as a result, receive payment outside the foregoing priorities. If there is an uncollateralized portion of their claim, that portion would be paid in the order of the claim – so an uncollateralized general creditor claim would be subordinated to administrative expenses and depositor claims.

Insured depositors receive access to their deposits virtually overnight after the appointment of the receiver, typically through the transfer of insured deposits to another FDIC-insured bank or through other arrangements made by the FDIC; only rarely are deposits paid out of the DIF in a liquidation.

The FDIC may take over the assets and operate the institution involved, collect all obligations and money due to the institution, perform all functions consistent with its appointment, and preserve and conserve the assets of the institution. The FDIC may merge the institution with another bank or transfer its assets and liabilities to another entity.⁶¹ The transferee may be another bank or a bridge bank⁶² created and managed by the FDIC to provide continuity and help maximize the value of the failed bank's assets where an immediate sale of the assets and liabilities to another bank is not possible.⁶³

Creditors are also assured that they will receive no less than they would have recovered in a liquidation of the bank.⁶⁴

⁶⁰12 U.S.C. § 1821(d)(11).

⁶¹12 U.S.C. § 1821(d)(2)(G).

⁶²See 436 BPS §IV-D8, Description of the receivership process.

⁶³12 U.S.C. § 1821(n).

⁶⁴12 U.S.C. §1821(i). This provision is structured in a confusing manner, but the effect is that creditors are guaranteed to receive no less than they would have if the FDIC had immediately liquidated the bank and not used its authority to create a bridge bank or other non-liquidation resolution method.

Unlike OLA, the FDIA does not include a specific provision protecting a creditor's right to set-off. However, set-off will apply in FDIC bank receiverships generally under the same principles and requirements applicable to set-off claims under state law. One important note is that, as under common law, an enforceable right to set-off requires that the claims be mutual as to both identity of the parties and priority of payment. As a result, the priority given to depositor claims, which includes the FDIC's right to recover funds expended by the DIF to protect insured depositors, may impair the rights of a general creditor seeking recovery against the FDIC.

Pre-insolvency

The FDIA requires certain federal regulatory responses when an insured institution's regulatory capital ratio falls below specified levels. This mandatory supervisory structure is intended to facilitate resolution of the problems of insured institutions at the least cost to the DIF by requiring the regulators to take 'prompt corrective action'.⁶⁵ Final planning and marketing for a bank resolution normally begins 90–100 days prior to the institution being placed into receivership, though the process may be accelerated in the event of a sudden failure. It begins when an FDIC-insured bank's problems appear to be severe enough to cause it potentially to fail. During this period the FDIC coordinates its actions – including the scheduling of the failure – with other regulators. When a bank becomes critically undercapitalized under the prompt corrective action standards,⁶⁶ the primary federal regulator has up to 90 days to close the institution and appoint the FDIC as receiver. The FDIC and the primary federal regulator generally require that the institution seek an acquirer or merger partner to avoid the necessity for appointment of the FDIC as receiver. The FDIC's authority to take over a failed or failing institution, thereby imposing the bank's losses on its stockholders and unsecured and uninsured creditors, not only provides an incentive for management to seek actively for an acquirer, but also encourages the institution's board of directors to approve (or recommend for approval to shareholders) such transactions to avoid the risk of an FDIC receivership.

During this planning phase, the FDIC collects as much information as possible about the institution and structures the resolution transaction. This information assists the FDIC in determining the best transaction structures to offer potential acquirers. The FDIC also values the institution's assets and determines which assets may be particularly problematic for an acquiring institution and may need to remain in the receivership for disposition after resolution or be covered by some level of risk protection. Qualified bidders are contacted to perform due diligence, subject to a confidentiality agreement. Due diligence is offered both onsite and offsite through the use of secure internet data rooms. Bidders are then asked to submit bids on the basis of the transaction structures offered by the FDIC. The FDIC analyses the bids received and accepts the bid that resolves the failed institution in the manner least costly to the DIF.

⁶⁵See FDIA § 38(a), 12 U.S.C. § 1831o(a).

⁶⁶ 12 U.S.C. § 1831.

Then, whenever possible at the point of failure, the institution is placed into receivership and then, if possible, immediately sold – with the sale resulting in a transfer of deposits and assets that renders the process seamless to insured depositors and, where the acquirer assumes those liabilities, uninsured depositors. The FDIC is also able to make an immediate payment, or advance dividend, on the obligations to uninsured creditors not assumed by the acquiring institution based upon estimated recoveries from the liquidation.

Alternatively, the FDIC may charter one or more bridge banks to which assets and liabilities of an insured bank may be transferred in the event of its failure. Fundamental to orderly resolution of more complex banks is the ability to continue key operations, services, and transactions that will maximize the value of the bank's assets. The bridge bank is a newly established national bank that permits the FDIC to stabilize the key operations of the covered financial company by continuing valuable operations.

Legal certainty

Legal certainty under the FDIA is provided by a statutory priority for distribution in the receivership, the defined powers for the resolution, the administrative claims process, and, following exhaustion of its remedies, the right to file a lawsuit on any claims.

Timeliness

The FDIA helps facilitate more timely resolutions of failing banks, but like any relatively discretionary process it does rely on the diligence of supervisory agencies and their willingness to act promptly. The process is described above under 'pre-insolvency'.

Once a resolution is initiated, the FDIA authorizes the FDIC to take immediate action to resolve the bank and does not require, in general, additional permissions to act. As a result, the FDIC typically makes an immediate transfer of most of the failed bank's assets and liabilities to another open bank or a bridge bank.

Germany

In Germany the legal environment for the management of distress banks is complex due to special regimes introduced both during and after the global financial crisis. Effectively, following BRRD implementation, the procedural framework has now adopted a dualistic structure, with the traditional pre-crisis hybrid combination of administrative measures and court-based liquidation still in place for cases outside the scope of the BRRD (i.e. failures which would not give rise to systemic stability concerns and therefore would not satisfy the 'public interest' test under the BRRD⁶⁷), while the BRRD has been transposed in the form of a separate German Recovery and Resolution Act, the

⁶⁷ See *supra*, text and n. [xxx].

Sanierungs und Abwicklungsgesetz.⁶⁸ The existing crisis management measures under the German Banking Act⁶⁹ were migrated into the German Recovery and Resolution Act, while the German Bank Restructuring Act⁷⁰ remains in force.

Initiation

For banks outside the scope of single supervision by the ECB, the initiation of insolvency procedures remains reserved to the Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht* or BaFin).⁷¹ This restriction has been in place since the fundamental reform of bank insolvency management in the aftermath of the failure of Bankhaus Herstatt in 1976. It precludes petitions by the bank company, its owners, and creditors. Whereas directors of companies facing illiquidity or balance-sheet insolvency are required by statute to file for insolvency⁷² this duty is replaced by a duty to inform BaFin.⁷³ In order to preserve the supervisor's full autonomy as to if and when to initiate formal court-sanctioned insolvency procedures.

Moratorium

Since the 1976 reforms responding to lessons learnt from the Herstatt failure, an 'administrative moratorium' has been the key instrument applied in all cases of bank insolvencies. Physical closure is combined with the closure of the relevant bank and all its branches, with a ban on disposals and payments, a stay of enforcement proceedings, and a prohibition to accept new deposits, as well as directions to managers and, where deemed necessary, the removal of managers and their replacement by trustworthy external staff.⁷⁴ The imposition of such measures effectively triggers broadly similar consequences as would be associated with procedural safeguards for the insolvent estate during the initial stages of formal insolvency proceedings.⁷⁵ The application of the German Restructuring Act is followed by a mandatory stay until the end of the next business day.⁷⁶

Management of the insolvency process

Under the traditional regime, the management of the insolvency process is confined to BaFin as the supervisory authority as long as formal insolvency procedures have not yet been initiated. Once

⁶⁸ Gesetz zur Sanierung und Abwicklung von Instituten und Finanzgruppen [Law on the Restructuring and Liquidation of Credit Institutions and Financial Groups], 10 December 2014, Bundesgesetzblatt [Official Journal] 2014 I, 2091. See e.g. J-H Binder, Germany, in G Moss, B Wessels, and M Haentjens (eds), *European Banking and Insurance Insolvency*, 2nd edn, OUP 2017.

⁶⁹ *Kreditwesengesetz* of 9 September 1998 (as amended), Bundesgesetzblatt I p. 2776.

⁷⁰ *Gesetz zur Reorganisation von Kreditinstituten (KredReorgG)* of 9 December 2010, Bundesgesetzblatt I p. 1900.

⁷¹ German Banking Act, section 46b(1), sentence 2.

⁷² German Insolvency Act, section 15a.

⁷³ German Banking Act, section 46b(1), sentence 4.

⁷⁴ German Banking Act, section 46(1).

⁷⁵ Cf. German Insolvency Act, sections 19–20, and, for a functional analysis of the parallels between the two regimes, J-H Binder, *supra* n. 24, at 255–60.

⁷⁶ KredReorgG, section 13.

BaFin has filed for insolvency under section 46b of the German Banking Act, the responsibility shifts to the insolvency court and the liquidator appointed by it under general insolvency law. In practice, this has happened only following the imposition of an 'administrative moratorium' in the sense explained above, which may take between a few days and a few months, depending on the size of the relevant institution, the complexity of its organization, its financial position *vis-à-vis* clients and professional counterparties, etc. Effectively, the imposition of a moratorium prior to the initiation of a formal insolvency procedure thereby secures a dominant position of BaFin during the initial stage of a bank crisis. This stage is particularly important in that following the imposition of the moratorium, insured depositors will have been paid off,⁷⁷ close-out and netting rights will have been invoked, and collateral rights will have been enforced before the insolvency court takes over. Although modern German insolvency law does provide for rather flexible, court-sanctioned restructuring procedures (including a debtor-in-possession procedure),⁷⁸ the function of insolvency procedures for credit institutions has effectively been confined to providing a procedural framework for the collection and distribution of assets and the dissolution of the insolvent company. In this process, case management is governed exclusively by general insolvency law, leaving the technical liquidation process to a court-appointed liquidator with some oversight by the insolvency judge and a creditors' meeting.⁷⁹ During this process, BaFin has special information rights under section 46b (3) of the Banking Act, but otherwise no control of the procedure and the economic implications.

Priorities, collateral, and set-off

As a rule, priorities, collateral, and set-off rights are governed by general insolvency law, set out in the German Insolvency Act.⁸⁰ In principle, subject to voidability of onerous transactions,⁸¹ collateral arrangements are respected in insolvency and will lead to preferential treatment of the respective creditor. The Financial Collateral Directive applies, as is the case in all EU countries. Likewise, a set-off right that has arisen prior to the initiation of the insolvency proceedings will continue to be exercisable. In this context, close-out netting arrangements have been accorded special protection under section 104(4) of the German Insolvency Act, which gives effect to contractual arrangements that deviate from the otherwise mandatory set-off rules under the German Insolvency Act.

On reflection, the German regime clearly demonstrates that exceptions to general insolvency principles on the grounds of systemic stability do not inevitably warrant the creation of a fully

⁷⁷ Depositors are entitled to a pay-out of insured deposits if an administrative moratorium under section 46(1) of the Banking Act has been in force for a period of more than six weeks at the latest, cf. section 10(2), sentence 2 of the German Einlagensicherungsgesetz (Deposit Insurance Act). In the past the declaration that the relevant institution is unable to meet its obligations to depositors, which gives rise to an immediate claim for pay-out of insured deposits (cf. section 10(2), sentence 1 of the Deposit Insurance Act), has frequently coincided with the imposition of the moratorium.

⁷⁸ See German Insolvency Act, Part VI ('Insolvenzplanverfahren', modelled after Chapter 11 of the US Bankruptcy Code) and Part VII ('Eigenverwaltung', a debtor-in-possession procedure).

⁷⁹ See, in particular, German Insolvency Act, sections 56–79.

⁸⁰ See, in particular, German Insolvency Act, sections 48–46 (ranking of claims), sections 46–52 (safeguards with respect to specific categories of rights *in rem*), and 94–96 (insolvency set-off).

⁸¹ See German Insolvency Act, sections 129–s47.

separate procedural framework. The very fact that the relevant provisions have been included in the general insolvency law framework rather than in the Banking Act (which merely refers to the Insolvency Act in this respect) clearly illustrates that substantive (as distinct from procedural) general insolvency law is generally capable of accommodating the specific characteristics of bank insolvency.

Recently, the principle of general applicability of the Insolvency Act has been modified slightly, with the introduction of a new insolvency preference for depositors in section 46f(4) no 2 of the Banking Act (transposing BRRD Article 108) as well as preferential treatment of non-bail-inable creditors pursuant to section 46f(5)–(7) of the Banking Act, which modifies the general ranking of claims under section 38 of the German Insolvency Act for that purpose. The effect is subordination of unsecured bondholders, thereby facilitating bail-in, i.e. statutory subordination.

Pre-insolvency

Owing to the hybrid combination of the ‘administrative moratorium’ and the application of general insolvency law described above, there is no clear-cut pre-insolvency stage that could be distinguished from the actual insolvency situation. It should be noted, however, that the German Banking Act has always provided for a number of instruments for use ahead of the outright imposition of a moratorium, by way of early intervention as soon as a particular credit institution has been identified as encountering financial problems or irregularities. Pursuant to the relevant provisions, BaFin may, inter alia, issue directions to the relevant institution and its management, prohibit or restrict the payout of dividends, restrict the provision of new loans, appoint a special investigator, and prohibit or restrict the activities of directors.⁸²

Legal certainty

Unlike early-intervention measures, which are addressed exclusively to the relevant institution and are confidential, the imposition of an administrative moratorium is made public immediately. The legal consequences are set out directly in the Banking Act and not determined on a discretionary basis, so both the institution itself and its counterparties can expect no lesser degree of legal certainty than they would enjoy following the initiation of general insolvency provisions, even though – unlike in formal insolvency – they are not party to the proceedings during the moratorium stage. Once BaFin has formally filed for the opening of insolvency proceedings under section 46b of the Banking Act (discussed above), all stakeholders are subject to the rules of general insolvency law, which ensure a high level of creditor information as well as influence on the decision-making process. Just as in ordinary corporate insolvency cases, the liquidator exercises his/her duties in the interest of the creditors as a whole, is accountable to the court and the creditors’ meeting, and can be held liable for breach of duties. All in all, this leaves the creditors in a substantially more comfortable position than they would be in a purely administrative procedure, especially in a BRRD-

⁸² See for details German Banking Act, sections 45, 45c, and 46.

style environment where the resolution authority has a high level of discretion with regard to the design of individual resolution actions.

Timeliness

The need to ensure effective, swift responses to problem cases was one of the reasons for the adoption of the traditional hybrid style of bank insolvency management in Germany in the aftermath of the Herstatt case. With the monopolization of the right to initiate liquidation procedures in the hands of the supervisory authority, coupled with the introduction of the 'administrative moratorium' as a rather forceful, comprehensive instrument to preserve the relevant bank's financial position and cut off dealings with third parties, the expectation was that the risk of a dramatic deterioration of the bank's financial position once it was found to be in trouble could be effectively stopped, while avoiding the time-consuming initiation procedure under general insolvency law until the situation could be stabilized. This was also attributable to the fact that there are no specialized insolvency courts in the German judiciary, so swift, competent and effective responses to the highly dynamic developments in the early stages of bank insolvency cases could not reliably be expected under general law. Judging from probably more than 300 cases to date, where an administrative moratorium was imposed and followed by the liquidation of the relevant bank under general insolvency law, this appears to have been broadly successful.

UK

The special resolution regime applicable to banks was introduced in 2008 to address the failure of Northern Rock. Initially an intermediate regime, it was transformed into a permanent resolution regime in 2009. It subsequently has been subjected to a series of reforms, culminating in an adaptation to the resolution framework envisaged by the BRRD. Thus, in contrast to the BRRD, the UK regime still contains substantial differences relating to the approach to resolution, as well as additional special insolvency and administration procedures.⁸³

Initiation

The UK has put in place special administration and insolvency arrangements for banks, investment banks, and building societies. These measures enable the UK to put into insolvency those banks where it is not in the public interest to initiate the Special Resolution Regime.⁸⁴ Part 2 of the Banking Act 2009 is concerned with the winding up of a bank based on the existing compulsory winding-up process for commercial companies, and is supplemented by the Bank Insolvency (England & Wales) Rules 2009. The process of applying for a bank insolvency order is modified as compared with the rules that apply in the normal procedures so there can be a court hearing without delay. There are three grounds for an application for an insolvency order in respect of a bank: the bank is unable to

⁸³ R Olivares-Caminal, J Douglas, R Guyn, A Kornberg, S Paterson, and D Singh, *Debt Restructuring* 2edn (OUP 2016) Part II Bank Resolution, 361–483.

⁸⁴ M Cohen and S Crooks, Bank Failures under the Banking Act 2009 (2012) 9(2) *International Corporate Rescue* 127.

pay or likely to become unable to pay its debts; it is in the public interest to wind up the bank; and it is fair to wind up the bank.

An application to court under the Banking Act to appoint a person as liquidator can be made by the Bank of England, the appropriate regulator, or the Secretary of State. Where an insolvency order is sought the court may only, exercising its discretion, make an order in respect of a bank if the court is satisfied that the bank has 'eligible depositors', i.e. depositors eligible for compensation under the Financial Services Compensation Scheme (FSCS).

Moratorium

To address the risk following disorderly early termination of transactions and enforcement of security rights, Banking (Special Provisions) Act 2008 provided for a moratorium. As a consequence, if a counterparty sought to enforce its contractual rights, it required the consent of HM Treasury. Failure to obtain the required consent resulted in the purported enforcement action becoming void. This tool was maintained until the introduction of the BRRD. Today it subsists as part of the Bank Insolvency Procedure and the Bank Administration Procedure, which include a power to put in place a moratorium procedure to manage creditors' interests in as orderly manner as possible and minimize disruption of the bank's vital functions.

Management of the insolvency process

The objectives of the insolvency and administration procedures are aligned with that of resolution; hence the objectives of rehabilitation of the debtor and satisfaction of creditor claims are subordinated to financial stability. After the application of transfer, the residual institution shall support the transferee or continue functions and services that are deemed essential to avert the further deterioration of financial market stability. In addition, the UK has in place a special bank insolvency procedure, modified to ensure eligible depositors are paid promptly under the FSCS.

The bank liquidator, who is an officer of the court, has two objectives. Objective 1 is to ensure that each eligible depositor has its account transferred to another financial institution or receives payment from the FSCS as soon as practicable. Objective 2 is to wind up the affairs of the bank so as to achieve the best result for the bank's creditors as a whole. Although the bank liquidator is required to begin working towards both objectives, Objective 1 'takes precedence' over Objective 2. To achieve the liquidator's objectives the bank is expected to have in place a file recording depositors' information consistently in a 'single customer view', which the bank liquidator is required to review before transferring the information to the UK FSCS for it to initiate payouts to customers of the bank. The general powers and duties of the liquidator are set out in section 103 of the Banking Act, which lists, with only minor modifications, the main provisions of the Insolvency Act 1986 that apply to non-banks. The members of the liquidation committee will be nominees of the Bank, the appropriate regulator, and the FSCS, and the liquidator is required to report to this committee.

Priorities, collateral, and set-off

Set-off has a longstanding tradition in English insolvency law. The underlying policy reason is that it would be inequitable if one were to enforce a claim without giving due regard to the obligation. Hence it would be inequitable for the liquidator or administrator to enforce all claims while disclaiming all obligations. This principle can be found in the inherent equitable jurisdiction of the courts. Here courts can apply set-off even without prior satisfaction of the strict requirements under the Insolvency Rules 2016, such as mutuality.⁸⁵ In contrast to German, Spanish, and US law, English law does not contemplate the prohibition of *ipso facto* clauses, i.e. clauses which allow termination upon imminent or actual insolvency. Hence to the extent that contractual provisions, e.g. found in collateral arrangements, are not prejudicial to the debtor or fellow creditors and thus subject to the voidance rules, set-off is enforceable in accordance with the terms of the arrangement. It is said that although legislators have implemented the Financial Collateral Directive by way of the Financial Collateral Arrangement (No 2) Regulations 2003, the actual effect is negligible in relation to enforcement of collateral.⁸⁶

Hence creditors subject to a set-off or collateral arrangement are loosely said to benefit from a higher priority. Given the policy reason set out above, set-off and collateral arrangements are accorded wide discretion, such that they can be largely enforced notwithstanding an imminent or actual commencement of a conventional insolvency or administration proceeding.

Pre-insolvency

The Prudential Regulation Authority (PRA) and in certain circumstances the Financial Conduct Authority (FCA) are responsible for making the determination that a banking institution or an investment firm is failing, or is likely to fail to satisfy the threshold conditions, and that it is not reasonably likely that action will be taken by or in respect of the institution that will enable the institution to meet those conditions. In this regard, options set out in the recovery plan are likely to be initiated. The PRA has introduced the Proactive Intervention Framework to explain the structure of its supervisory decision-making process as its judgement about a firm's viability changes and it considers the firm to be near 'proximity to failure'.⁸⁷

⁸⁵ Mutuality means that the claims and obligations must be reciprocal between two parties. The underlying policy rationale is that one's assets cannot be used to satisfy a third party's claims.

⁸⁶ However, there are benefits related to perfection, substitution, and appropriation of collateral. Discussion of the benefits is beyond the scope of this paper.

⁸⁷ The Proactive Intervention Framework is set out in five stages: Stage 1 – Low risk to viability of firm; Stage 2 – Moderate risk to viability of firm; Stage 3 – Risk to viability absent action by the firm; Stage 4 – Imminent risk to viability of firm; Stage 5 – Firm in resolution or being actively wound up.

In some respects the Special Resolution Regime Code of Practice 2017 confers on the PRA and the FCA wider discretion to determine whether an institution is failing or likely to fail by eliminating the need to determine this with reference solely to the threshold conditions.⁸⁸

Timeliness

The automation of information on single customer views and exclusions within 24 hours provides the basis for a firm to be able to transfer eligible deposits to achieve the desired stabilization option or administration.

The Banking Act 2009 also confers some additional express powers on the bank liquidator: the power to insure the business and property of the bank, the power to do all such things (including carrying out of works) as may be necessary for the realization of the property of the bank, and the power to make any payment which is necessary or incidental to the performance of the liquidator's business. The implication of the addition of these express powers is that the legislature has taken the view that the powers do not fall within the liquidator's general powers, in a normal liquidation, to carry on the business of a company so far as may be necessary for its beneficial winding up or the power to do all such things as may be necessary for winding up the company's affairs and distributing its assets. The bank liquidator may not apply to the court for directions in relation to any particular matter arising in the winding up, and a person aggrieved by an act or decision of the bank liquidator may not apply to the court unless the liquidation committee has passed a full payment resolution, i.e. until the committee has resolved that Objective 1 (ensure that each eligible depositor receives payment from the FSCS as soon as practicable) has been achieved insofar as is reasonably practicable.

Legal certainty

In view of the policy reason set out above, set-off and collateral arrangements are accorded wide discretion, such that they can be largely enforced notwithstanding an imminent or actual commencement of a conventional insolvency or administration proceeding. Section 112 of the Financial Markets and Services Act 2000 represents a significant exemption, since it allows the UK regulator to stay and suspend any agreement. However, it does not enable the regulator to tear up contracts.

⁸⁸ HM Treasury, Banking Act 2009: Special Resolution Regime Code of Practice, March 2017, 6.13-6.30.
https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/602948/Special-Resolution-Regime-Code-of-Practice.pdf

Spain⁸⁹

As is the case in Germany, with the transposition of the BRRD to the Spanish law in 2015⁹⁰ the bank insolvency process became a dual system: an administrative process to deal with bank recovery and resolution in the context of the Single Resolution Mechanism, and a court-based process⁹¹ in conjunction with administrative measures to deal with bank liquidation. As it is the case in Germany, some special legislation applies to dealing with insolvent banks in Spain.

Initiation

Initiation of insolvency proceedings is part of the role of the supervisor (the ECB for significant institutions and the Bank of Spain for less significant institutions). Also, the 'debtor' credit institution is entitled to petition for insolvency proceedings to be opened, and is obliged to communicate to the bank supervisor. If bank liquidation under normal insolvency proceedings is feasible and credible, the Bank of Spain (less significant institutions) sets the conditions within three months of the date of the formal petition.⁹² The Ministry of Economy has the power to decide its participation in the bank liquidation based on the public interest. The court has to examine the petition to declare the insolvency proceedings open and decide on their admissibility.⁹³ In Spain, the legal right to close a bank is reserved to the court. The legislation does not define a closure rule, but defines the grounds that trigger the proceedings on which parties are entitled to initiate such proceedings, and on which judicial authority is in charge.

Moratorium

The opening of insolvency proceedings alone has no effect on the validity of contracts with pending reciprocal obligations. Moratorium and suspension of contracts are provided upon application to a bankruptcy court. The moratorium (full or partial suspension of payments and a stay of contract enforcement) is necessary to protect depositors and avoid dissipation of financial resources or the legal process of seizing property by certain creditors to the detriment of others.

Management of the insolvency process

Once the supervisor sets the conditions for liquidation, the process is managed by the court under the General Insolvency Act,⁹⁴ which acknowledges (Additional Provision 2) the specialties for bank

⁸⁹ For a historical perspective of corporate bankruptcy procedures in Spain see Van Hemmen (2007–2014): *Estadística concursal*. Anuario 2006. Colegio de Registradores de la Propiedad y Mercantiles de España, Madrid

⁹⁰ Legal Act 11/2015, 18 June, on Recovery and Resolution of Credit Institutions and Investment Firms.

⁹¹ Act 22/2003, 9 April, on Insolvency, amended by Act 9/2015, 26 May, on Urgent Measures regarding Insolvency and Act 6/2005, 22 April, on Restructuring and Winding-up of Credit Institutions.

⁹² Legal Act 11/2015, Additional Provision 15.

⁹³ Once the court has adopted a preliminary decision, it notifies the Bank of Spain and the National Stock Exchange Commission requesting a list of the payment and clearing systems for securities and derivative financial instruments to which the affected firm belongs.

⁹⁴ Act 22/2003, 9 April, on Insolvency, amended by Act 9/2015, 26 May, on Urgent Measures regarding Insolvency (Title II).

insolvency situations established in specific legislation for banks: ‘except those related to the composition, the appointment and operation of the insolvency practitioner under insolvency law (bankruptcy receiver)’. Once the insolvency proceedings are declared open, the court appoints the insolvency practitioner (receiver) to coordinate the liquidation process (e.g. paying employees, partial payment of claims) and reduce the information asymmetries between creditors and debtors. The court decides on the insolvency practitioner’s status, sets out its legal powers and its exercise thereof, the giving of accounts, and, when appropriate, its liability. All creditors, ordinary or otherwise and whatever their nationality, are entitled to be represented in the bankruptcy procedure. Creditors are integrated *de jure* in the aggregate liabilities of the insolvency proceeding, with no exceptions other than those established in law. Disagreements among creditors (e.g. inclusion or exclusion of claims, or the amount or ranking of those claims) are dealt with by the court. Hence the management of the bank liquidation process is governed by the general insolvency law, and specific legislation for banks covers, in particular, rights *in rem* (i.e. property rights) and certain set-off and close-out netting arrangements and collateral arrangements.

Priorities, collateral, and set-off

Once insolvency proceedings are initiated, the general insolvency law does not allow set-off in an ordinary insolvency procedure.⁹⁵ However, under the special regime applicable to credit institutions, investment service companies, and insurance undertakings, set-off rights that have arisen prior the declaration of insolvency will continue to be exercisable (Additional Provision 2).⁹⁶

Also, the EU harmonized regime applies to financial collateral and is enshrined in the Insolvency Act, which protects against potential negative economic consequences (e.g. securing the continuity of the creditor’s activity) in the initial stage prior to the formal opening of insolvency proceedings and in the course of the proceedings. The special regime applicable to credit institutions envisages that the enforcement of property rights recorded in a register, account, or centralized deposit system located in Spain is governed by Spanish law (*lex rei sitae*).⁹⁷

For banks, the 2015 Law that transposes the BRRD into the Spanish legal framework introduced a tiered depositor preference regime in which insured depositors rank higher than eligible deposits, but uninsured deposits still rank higher than other short-term liabilities.⁹⁸ The 2015 Law also introduces a tiered preferential treatment of “subordinated claims,” according to which subordinated debt holders rank higher than Additional Tier 1 or Additional Tier 2 capital holders.⁹⁹

⁹⁵ *ibid* Article 58.

⁹⁶ *ibid*.

⁹⁷ Act 6/2005 on Restructuring and Winding-up of Credit Institutions, Article 8.1(d) and (e).

⁹⁸ Act 11/2015, 18 June, on Recovery and Resolution of Credit Institutions and Investment Firms.

⁹⁹ *Ibid* (Additional Disposition 14th).

Pre-insolvency

For banks outside the scope of single supervision by the ECB, the Bank of Spain has at its disposal a large variety of tools for intervention.¹⁰⁰ In particular, supervisors have the ability to place the management of a distressed bank under the control of appointed officials (*interventores*) in extremely grave circumstances (other than those envisaged in Act 11/2015 on Recovery and Resolution of Credit Institutions) in which ‘stability, liquidity or solvency’ is jeopardized.¹⁰¹

The Bank of Spain, as bank supervisor, has broad authority to take remedial action, about which it should inform the government and the resolution authority (FROB).¹⁰² The agreement to intervene and replace one, more, or all members of the board of directors could be *ex officio* or at the instance of the bank’s management or internal control body. The agreement is made public in the Official Gazette. Any action taken without the prior approval of the *interventores* is considered null and void.

The Bank of Spain is fully responsible for modifying and ceasing intervention and substitution measures for non-significant banks. If a bank cannot be made viable under provisional administration, the alternative is liquidation. The bank may also voluntarily decide to be liquidated. The court will inform the Bank of Spain (or the ECB) and FROB of this decision. The Bank of Spain and FROB decide whether the bank will be subject to resolution or liquidation, and inform the court within seven days.¹⁰³ In the latter case, the court-based bankruptcy procedure is set in motion.

Legal certainty

In ordinary bankruptcy procedure bank creditors’ agreement or composition is legally binding on ordinary and subordinated creditors holding claims that take priority when insolvency proceedings are declared open.¹⁰⁴ Claims held by creditors who have voted in favour of the composition (preferential, ordinary, and subordinated) are extinguished for the part covered by the write-down of debts and postponed by the moratorium on payment. Although a straight priority of claims applies in liquidation, creditors participate in a renegotiation of their claims,¹⁰⁵ the outcome of which can be challenged by any creditor subject to court approval.

¹⁰⁰ Provisional administration in the pre-insolvency phase is regulated by Law 10/2014 on the Regulation, Supervision and Soundness of Credit Institutions, Chapter V, Articles 70–79.

¹⁰¹ *Ibid.*

¹⁰² The Bank of Spain is responsible for ‘preventive’ resolution authority and FROB is responsible for the execution of resolution schemes. The Bank of Spain is responsible of the preparation phase, which includes the drafting of bank resolution plans in cooperation with the Single Resolution Board. *ibid* Article 2.1(c).

¹⁰³ Law 10/2014 on the Regulation, Supervision and Soundness of Credit Institutions, Article 77. The Bank of Spain reports annually to the Spanish Parliament on its regulatory intervention and resolution measures. The Ministry of Economy has the power to intervene in bank liquidation based on the public interest. Act 11/2015, 18 June, on Recovery and Resolution of Credit Institutions and Investment Firms, Additional Provision 15.

¹⁰⁴ Certain majorities are required for creditors to accept a proposal for composition. Act 22/2003, 9 April, on Insolvency, amended by Act 9/2015, 26 May, on Urgent Measures regarding Insolvency, Article 124.1.

¹⁰⁵ Act 22/2003, 9 April, on Insolvency, amended by Act 9/2015, 26 May, on Urgent Measures regarding Insolvency, Title IV, Chapter IV and Title V, Chapter I.

Timeliness

Regarding initiating the liquidation process, the supervisor can appoint a provisional administrator with all the powers to administer, manage, and represent the bank as soon as the bank's financial situation deteriorates and it cannot meet the minimum regulatory requirements in the foreseeable future, or in other extraordinary circumstances that can jeopardize the bank's solvency.¹⁰⁶ However, the initiation of liquidation could also be voluntary by the creditor bank (non-significant institutions). This possibility lends itself to delayed initiation of the court-based liquidation process to the extent that the supervisor does not take the initiative.¹⁰⁷

Regarding resolution of the insolvency and paying depositors, in bank insolvency (as with corporate bankruptcy) there is no immediate resolution and the average time from the petition to open the insolvency proceedings to its conclusion may be long and variable. Procedural requirements and publicity involved in formal judicial proceedings (e.g. creditors' meeting) lengthen the bankruptcy process, and so may exacerbate liquidity and credit losses. On average, the time to enforce a contract through the courts is approximately 17 months.

The deposit insurance scheme (*Fondo de Garantía de Depósitos*) obliges the insurer to pay compensation in case bankruptcy has been declared or a deposit becomes 'unavailable', i.e. when the deposit has become due but has not been paid. The supervisor must declare any present or shortly foreseeable 'unavailability'.¹⁰⁸

¹⁰⁶ The withdrawal of the bank's license would lead to winding-up.

¹⁰⁷ Act 22/2003, 9 April, on Insolvency, amended by Act 9/2015, 26 May, on Urgent Measures regarding Insolvency, Article 2.

¹⁰⁸ Royal Decree 16/2011, 14th Octubre establishes the Spanish deposit insurance scheme (*Fondo de Garantía de Depósitos*) (Article 8).

Table 1: Institutional framework for bank resolution and liquidation: Selected countries

	Are resolution and liquidation under the same <u>authority</u> ?	Are resolution and liquidation regulated in the <u>same law</u> ?	<u>Who</u> can close a Credit Institution (CI)?
US	Yes Resolution of deposit-taking institutions: Federal Deposit Insurance Corporation (FDIC) SIFIs including bank holding companies, non-bank financial companies including insurance brokers and dealers Title II of the Dodd-Frank Act establishes a special insolvency regime under the Orderly Liquidation Authority (OLA)	No 1991 Federal Deposit Insurance Act (FDIA) 2010 Dodd-Frank Act (Title II) establishes a special insolvency regime under OLA for SIFIs, including bank holding companies	Chartering authority or FDIC for insured banks SIFIs including bank holding companies, and non-bank financial companies such as insurance brokers and dealers: OLA requires recommendations from super-majorities of the board of governors and the FDIC and a decision by the Treasury Secretary in consultation with the President
Germany	Yes German Federal Agency of Financial Stabilisation (<i>Bundesanstalt für Finanzmarkt-stabilisierung</i> or <i>FMSA</i>), which forms part of BaFin (Resolution) Court (liquidation)	No Resolution: (i) German Restructuring Act or (ii) German Recovery and Resolution Act supplemented by German Banking Act Liquidation: German Insolvency Act	BaFin and ECB (revoking bank licence) Court
France	Authority for Prudential Supervision and Resolution (<i>Autorité de contrôle prudentiel et de résolution (ACPR)</i>) (resolution), which forms part of French central bank (Banque de France) (resolution) Court (liquidation)	No	ACPR and ECB (revoking bank licence) Court
Italy	Bank of Italy (resolution) Liquidator in consultation with the Bank of Italy (liquidation)	No Resolution: Decrees No 180/2015 and No 181/2015 implemented the Bank Recovery and Resolution Directive; Legislative Decree No. 385 of 1 September 1993, as subsequently amended and supplemented [Liquidation: Royal Decree No 267 of 16 March 1942 on Insolvency, Composition with Creditors and Compulsory Administrative Liquidation, as subsequently amended and supplemented][Needs to be confirmed by Italian lawyer]	Minister for the Economy and Finance on the Bank of Italy's proposal. The Bank of Italy appoints liquidator, who will act under its supervision.
Spain	No FROB and Bank of Spain (resolution) Court (liquidation)	No Resolution: Legal Act 11/2015, 18 June, on Recovery and Resolution of Credit Institutions and investment Firms Liquidation: Act 22/2003, 9 April, on Insolvency, amended by Act 9/2015, 26 May, on Urgent Measures regarding Insolvency. Act 6/2005, 22 April, on Restructuring and Winding-Up of Credit Institutions	ECB/BoS (revoking bank licence) and FROB Court
UK	Yes Bank of England (BoE) (resolution) Insolvency practitioner appointed by Bank of England in consultation with the PRA and Secretary of State in specific instances	Systemic relevant institutions as defined by BoE: Banking Act 2009 – BIP and BAP Non-systemic relevant: Insolvency Act 1986 and Insolvency Rules 2016 Non-systemic relevant: Insolvency Act 1986 and Insolvency Rules 2016	PRA (power to revoke bank permission)
Switzerland	Yes FINMA	Yes (Ordinance of 30 August 2012 of the Swiss Financial Market Supervisory Authority on the Insolvency of Banks and Securities Dealers (Banking Insolvency Ordinance, BIO-FINMA) 109	FINMA (supervision, resolution, and liquidation)

¹⁰⁹ Recent amendments of the provisions of the Swiss Federal Banking Statute of 8 November 1934 (the 'Banking Statute') on the recovery and resolution of banks and securities dealers, substantially amended in 2004, 2011, and 2012, respectively.

Table 2: Bank insolvency in Germany, the UK, and Spain

	Initiation	Moratorium	Insolvency management	Priorities/collateral/set-off	Pre-insolvency	Timeliness	Legal certainty
Germany	BaFin/ECB	Mandatory BaFin administered	BaFin (pre-insolvency) Court (insolvency)	Financial Collateral Directive Tiered depositor preference Statutory subordination of specified debt instruments in insolvency ranking	BaFin/ECB administered No clear-cut pre-insolvency stage	BaFin/ECB decide initiation	Insolvency Law ensures high level of creditor information Publicity for moratorium
UK	BoE/PRA Secretary of State	Mandatory Bank of England	BofE – Court/Bank Liquidator	Financial Collateral Directive Tiered depositor preference Tiered preferential treatment of subordinated creditors	PRA/FCA/BofE No clear cut pre-insolvency stage but places specific focus on risks to the viability of the firm	Proactive intervention framework (PRA) Single customer view in 72hr Express powers to liquidator above ordinary bankruptcy	Clearly stated two objectives of liquidation Law clearly spells out grounds to apply for an insolvency order
Spain	Bank of Spain (BoS)/ECB Credit institution	Application to court	Court/bank liquidator	Financial Collateral Directive Tiered depositor preference Tiered preferential treatment of subordinated creditors	BoS/ECB Clear-cut distinction between pre-insolvency and insolvency	BoS/ECB If liquidation initiated by CI, bankruptcy initiation requires time-consuming general shareholders' meeting decision	Law clearly spells out grounds to apply for an insolvency order Liquidation formally decided by the bank's general shareholders' meeting Creditors' agreement legally binding

Table 3

Name of Bank	ECB Significant Bank	Other Systemically Important Institution	Resolution – Within Public Interest Threshold	Liquidation – Outside Public Interest Threshold
Banco Popular Español	✓	✓	✓	
Banca Popolare di Vicenza SpA	✓	✗	✗	✓
Veneto Banca SpA	✓	✗	✗	✓
ABLV Bank Latvia (parent)	✓	✓	✗	✓*
ABLV Bank Luxembourg (subsidiary)	✗	✗	✗	✓*

